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EX PARTE

July 8, 1998

Magalie Roman Salas, Secretary
Federal Communications Commission
1919 M Street NW, Room 222
Washington, DC 20554


Re: CC Docket No. 97-211
WorldCom, Inc. and MCI Communications Corporation

Dear Secretary Salas:

Enclosed, pursuant to Section 1.1206(b)(1) of the Commission's Rules, 47 C.F.R. § 1.1206(b)(1)(1997), are two copies of the "Reply Declaration of Robert E. Hall" to be included in the above-referenced docket as a written *ex parte* presentation.

Should there be any questions concerning this matter, please contact the undersigned.

Sincerely,


Larry A. Blosser

cc: Michelle M. Carey
Michael Pryor
Michael Kende
Marilyn Simon
Bill Bailey
Jennifer Fabian
Matt Nagler

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of)	
)	
Applications of WorldCom, Inc., for)	
Transfers of Control of MCI)	
Communications Corporation)	CC Docket No. 97-211
)	
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REPLY DECLARATION OF ROBERT E. HALL

I.	INTRODUCTION.....	1
II.	FOCUS OF THE MERGER ANALYSIS	1
A.	Scope of the reply affidavits.....	1
B.	Role of resellers.....	2
III.	THE ACTUAL STATE OF COMPETITION IN LONG DISTANCE.....	5
A.	Prices, margins, and access charges.....	5
B.	Wholesale prices and concentration.....	7
C.	Dr. Harris's Study of Rack Rates and Market Shares	8
IV.	BARRIERS TO EXPANSION AND ENTRY	9
A.	Modes of entry	9
B.	Are efficiencies claimed for the merger evidence of barriers to entry?	10
V.	EFFECT OF THE MERGER ON WORLD COM'S ROLE AS A SUPPLIER OF WHOLESALE SERVICE.....	11
VI.	SUPPLIERS TO NEW LONG-DISTANCE CARRIERS	12
VII.	EFFICIENCIES.....	14
VIII.	EVIDENCE FROM THE STOCK MARKET	14
IX.	INFERENCES FROM ENTRY	15
X.	DO INCUMBENTS HAVE A COST ADVANTAGE?	15
XI.	CONCLUSION	16

I. Introduction

1. I have been asked to prepare an economic analysis of the Reply Affidavits of Robert Harris (June 8, 1998) and Richard Schmalensee and William Taylor (June 9, 1998) in this matter.

2. My qualifications and the general framework of my analysis appear in my earlier declaration, dated January 25, 1998. I will not repeat that analysis, nor does this declaration attempt to respond to every element of the Reply Affidavits.

II. Focus of the Merger Analysis

A. Scope of the reply affidavits

3. The evaluation of the proposed merger, with respect to the long-distance market, should focus on the interests of consumers. It is only a slight oversimplification of the merger as it relates to long distance to say that the merger is desirable if it will lower prices and undesirable if it will raise them. The reply affidavits of Drs. Harris, Schmalensee, and Taylor do not tackle the question of the effect of the merger on prices to consumers, however. Their focus is on the price that resellers will pay for wholesale service. At best, their analysis falls into the category of suggesting that a "price squeeze" will occur, that is, an entity with substantial transmission and switching facilities and in addition a substantial long distance marketing capability will raise the price of resold (transmission and switching only) service to a rival with only marketing capabilities.

4. The analyses of Drs. Harris, Schmalensee, and Taylor are exceptionally narrow. They give no credit to the active competition that currently prevails among many long-distance sellers who have their own transmission and switching facilities and also marketing capabilities. The larger sellers operate with national networks that they own themselves. Other sellers use combinations of owned and leased capacity. Their analysis considers only pure resellers—those who take retail orders but provide service by reselling service of a full-service long-distance seller.

B. Role of resellers

5. The term *reseller* covers a multitude of types of carriers:

- pure or switchless resellers,
- carriers that have their own switches and lease fiber capacity from other carriers,
- carriers that have their own switches and lease some fiber capacity, own some fiber on routes not shared with other carriers, and own some fiber on routes that are shared with other carriers.

6. In a sense, almost every carrier is a reseller by the broadest definition. Even WorldCom and MCI use some leased capacity to serve their own long-distance customers. Thus the same firm can operate as both a customer and a supplier in the long-distance service and facilities market. GTE owns long-distance switching and transport capacity of its own and also resells long-distance capacity of other carriers.

7. The services purchased at wholesale by a switchless reseller are essentially the same services that retail customers purchase. When MCI sells a private line (as a vertically integrated retailer), it sells the same line and the same service whether the buyer is a retail customer or another carrier. Similarly, resellers buy switched services under the same tariffs as retail customers do. MCI offers a few services tailored to resellers, but these are basically the same services available to retail customers with a few extra capabilities and some restrictions designed to prevent slamming. The only meaningful difference is in the nature of the marketing activity, which differs somewhat across residential customers, business customers, and pure resellers. But all types of selling require sales forces. On the supply side of the market, there is too little differentiation to place wholesale supply in a different market from supply to business customers.

8. Mass marketing may create a difference between wholesalers and retailers for residential and small business customers. Mass marketing involves distinct expertise and capability that some carriers, such as WorldCom, have chosen not to develop or to develop only to a limited extent. Telemarketing and advertising capability have economies of scope more than economies of scale. Whatever economies of scale are present in billing and related services can be exploited by suppliers with multiple customers—for example, WorldCom provides billing and other capabilities for switchless resellers.

9. My understanding is that WorldCom has all of the same basic telecom capabilities (transmission, switching, routing, network management, billing, and the like) that MCI has, and it provides the same services, including Dial 1 switched service (to business customers and non-residential or small businesses through mass market channels). MCI has all of the basic capabilities that WorldCom has. The major difference is that MCI has a much larger mass marketing capability.

10. The reply affidavits present a tremendously simplified account of the relationships among the players in modern long distance. They focus exclusively on GTE's desire to purchase wholesale services in order to function as a switchless reseller, despite the fact that GTE, like many other long-distance carriers, already has and uses other sources of long-distance capacity.

11. Recent experience should provide new information about the role of resellers. Since 1994, SNET has offered resold long-distance service to its local customers in Connecticut (including this writer). More recently, GTE, which has been in the long distance business for many years using its own facilities, has become a reseller of long distance in its local markets.

12. Despite these obvious opportunities for a test of the hypothesis that resellers with advantageous wholesale supply agreements are able to offer lower retail long-distance rates, both reply affidavits are utterly silent on whether or not they do. Presumably Dr. Harris could have obtained revenue per minute figures from his client GTE, but he does not report any data of that sort. Does GTE beat the roughly 13 cents per minute that ATT, MCI, and Sprint charge on the average? The reader is left in the dark on this critical issue. Based on the rates that can be found in GTE's web site, it is almost certain that GTE does not beat the rates actually charged by the three large long distance companies. GTE offers two plans, "Total Call" and "Easy Savings." The lowest rate on Total Call is 14 cents per minute, for direct dialed calls. On the Easy Savings plan, the rates for peak usage are all above 20 cents per minute regardless of discount. The rates off-peak can be 0.126 or 0.105, but only for customers whose long distance usage is more than \$10 or \$25 per month, respectively. It thus seems very unlikely that GTE beats the 13 cents per minute.

13. In Connecticut, SNET is among the high-priced long-distance sellers. It does not come close to the 9 cents per minute that any Connecticut customer, irrespective of monthly purchases, can obtain from MCI by placing the order through MCI's Internet site, www.MCI.com, and providing a credit card number for billing.

14. Part IV of Drs. Schmalensee and Taylor's affidavit tries to argue that resellers in general have had a favorable role in the market. But here they adopt a broad definition of a reseller—it is any carrier other than AT&T, MCI, Sprint, or WorldCom. Many of these carriers operate their own facilities or lease facilities. Carriers treated as resellers include Electric Lightwave, Excel/Telco, Frontier, and GST. All that can be concluded from the data on market share is that sellers other than the largest four have a growing role in the market, a fact that is not in dispute.

15. Drs. Schmalensee and Taylor also present data on revenue per minute obtained from PNR. In these data, the smaller carriers have somewhat lower revenue per minute than MCI and Sprint and a larger price advantage over AT&T. These findings are not surprising, given the inherent limitations of the PNR data. Careful shoppers currently get the best possible deal from MCI at 9 cents per minute; there are many reasons to suspect that these customers are underrepresented in the PNR data. Given the unexplained discrepancies between the PNR data and revenue per minute calculated from the financial records of carriers (discussed in the next section), the data on small carriers should be used with caution.

16. Nothing in the evidence presented by Drs. Schmalensee and Taylor supports any conclusion about the role of resellers. They present no data on switchless resellers and have avoided discussion of actual rates charged by the two test cases of GTE and SNET. GTE's published rates make it seem very unlikely that GTE's average revenue per minute will be below the 13 cents of MCI, Sprint, and ATT. And of course, GTE and SNET are not ordinary resellers. It may well be that the experience of GTE and SNET as resellers reflects more on their role as monopoly local telephone companies who also sell long distance service than their role as resellers as such.

III. The Actual State of Competition in Long Distance.

A. Prices, margins, and access charges

17. The reader of the reply affidavits not otherwise in touch with the market would never guess how cheap long-distance service has become in the United States. Today anyone can buy long distance service from MCI for 9 cents per minute on Monday through Saturday and 5 cents on Sunday. This rate is available to any subscriber anywhere in the country who has both a credit card and access to Internet service, simply by placing an order through MCI's Internet site and providing a credit card number for billing. There is no minimum and no monthly fee.

18. Dr. Harris confirms the essentially competitive nature of long distance in his estimates of the relation of price to marginal cost (paragraph 97 and Exhibit 5). Dr. Harris uses my figure of 13.5 cents per minute as the average price of long distance, subtracts 6.7 cents in access charges, 1.0 cents in network costs, and 3.7 cents in other variable costs to get a margin of 2.1 cents per minute, or 16 percent of price. Given that the cost concept here is pure marginal cost, this finding places long distance toward the more competitive end of American industries.

19. Long distance is not a "textbook" perfectly competitive industry, nor will it ever be. Though the products of different sellers are extremely close substitutes technically, they have brand names and are perceived as differentiated products by the public. Sellers invest in acquiring customers. Some customers lack the incentive or propensity to search for the best possible deal; others are careful shoppers. There are differences in the costs of serving customers and there are fixed costs. The pricing of long distance can only be understood with these factors in mind.

20. Dr. Harris dwells in the distant past in his discussion of long-distance pricing. During the period when MCI and its rivals were switching from complicated plans involving discounts off list prices, such as Friends and Family, to simple low flat rates, MCI reduced the discount rates on the obsolete plans. Dr. Harris, in paragraph 98, interprets this as a price increase, when in fact customers were moving enthusiastically to MCI's flat rates of 15, 12, and now 9 cents, with rapid declines in revenue per minute. Prices were falling by any reasonable measure during the time when Dr. Harris suggests they were rising.

21. Drs. Schmalensee and Taylor discuss their data on revenue per minute (pp. 45-51). In my earlier affidavit and in earlier writings on long distance, I have advocated the use of revenue per minute as the best available measure of long-distance prices. Measures based on list prices have become grossly inaccurate both for the levels and changes in long-distance prices. In my work, I have taken the actual revenue data reported by carriers and divided by minutes of service. Currently, residential and business services together generate average revenue of about 13 cents per minute.

22. Drs. Schmalensee and Taylor's discussion of this issue does not mention the concept of revenue per minute that I have used. Instead, they use data from PNR and Associates, obtained from households. I have earlier pointed out discrepancies in these data which reveal that they do not adequately represent customers who pay low prices. The same discrepancy pervades the new results presented by Drs. Schmalensee and Taylor. They report revenue per minute of 16.9 cents for AT&T, MCI, and Sprint in 1997 when my calculations show less than 14 cents. In addition, their finding that revenue per minute rose for MCI from 15.9 cents in 1996 to 16.6 minutes in 1997 is flatly contradicted by data I have studied based on *all* of MCI's residential customers (not just the ones willing to sell their phone bills in the PNR survey), which shows declines from 1996 to 1997 and from 1997 to 1998.

23. Dr. Harris repeats his erroneous conclusion that the larger long-distance carriers have failed to pass through reductions in access charges. He states: "In fact, the Big Three have each raised their rates on their existing business customers at least seven times since 1992" (paragraph 44). In reality, prices for both business and residential customers have fallen precipitously over that period, as I showed in my January declaration. The declines in prices have been larger than declines in access charges. In particular, over the past year, when access charges fell more than usual as a result of an FCC initiative, MCI's business and residential rates each fell by more than the access charge reduction. In calculating revenue per minute in reaching this conclusion, I included the revenue that MCI now collects as a result of billing customers separately for new costs recently imposed by the FCC on long-distance carriers.

B. Wholesale prices and concentration

24. Dr. Harris observes that there is some price variation in wholesale markets. He refers to one of WorldCom's published tariffs for switchless resellers, called Transcend. This tariff has three geographic tiers. Traffic to and from the tier containing areas with the bulk of the population is charged 4 cents per minute. Traffic to or from the other two tiers, containing 38 percent of the population, is charged 4.5 or 5 cents per minute. Among the many differences among the tiers he finds modest differences in the degree of presence of AT&T, MCI, Sprint, WorldCom, and Frontier (all other carriers are ignored in Dr. Harris's calculations). Absent data on the key determinant of prices in competition—cost (for example, geographic differences in price may reflect geographic differences in access charges)—no conclusion at all about competition follows from the data.

IV. Barriers to Expansion and Entry

A. Modes of entry

29. As I stressed in my January declaration, the reason that the long-distance market is effectively competitive is that barriers to expansion and entry are low. Drs. Harris, Schmalensee, and Taylor dispute this conclusion. As I noted at the beginning of this declaration, their analysis does not take the consumer perspective generally adopted in modern analysis of competition, regulation, and antitrust. With respect to entry, they do not ask if entry will occur as needed to provide the consumer with the cheapest possible long-distance service. Instead, they ask if entry will take the particular form they believe is needed to supply a switchless reseller. They consider only how long it would take an entrant to build a complete national full-service wholesale supplier similar to WorldCom.

30. There may be efficiencies and complementarities from integration, but only to a point. There also may be efficiencies from reselling service, also, only to a point. Whether equilibrium will eventually tilt more toward resold service or more toward facilities-based retail service, the single-minded focus on potential entry at the wholesale level is off the point. Again, the key question is whether *some* form of entry will occur if prices of long-distance service to customers are above cost. It is not a harm to consumers if a company is unable to compete as a pure reseller because facilities-based rivals are more efficient, just as it is not a harm to consumers if the resellers outcompete the facilities-based retailers.

31. Merger analysis considers barriers to expansion and barriers to entry on the same plane. Tellingly, Drs. Harris, Schmalensee, and Taylor are completely silent on barriers to expansion. Many of the factors that they believe would hold back an entrant do not apply to an incumbent. Smaller facilities-based carriers like Excel/Telco, Frontier, and Cable & Wireless have solved many of the problems listed by Drs. Harris, Schmalensee, and Taylor.

32. Drs. Harris, Schmalensee, and Taylor stick rigidly to the self-imposed framework of entry that replicates WorldCom. They dismiss other forms of entry and expansion that would help the consumer but not the would-be reseller who stubbornly limits its suppliers to clones of WorldCom. In paragraph 28, Drs. Schmalensee and Taylor state "Once the backbone fiber is in place, entrants must still overcome the time-consuming, costly process to develop the other inputs needed to offer a complete wholesale package. It would be risky and uneconomical for them to deploy all the other components for a full wholesale long-distance service before determining whether and from what geographic and product markets demand may (or may not) develop." They go on to describe just what would be required to clone WorldCom.

33. And why would it be risky to undertake the form of entry prescribed by Drs. Harris, Schmalensee, and Taylor? Because other forms of expansion and entry occur so much faster that the profit opportunities would have been long exhausted by the time that the sequence they prescribe is complete.

B. Are efficiencies claimed for the merger evidence of barriers to entry?

34. Dr. Harris suggests that the efficiencies calculated by MCI and WorldCom demonstrate that there are increasing returns to scale in the long-distance business. As he notes, if the larger firms in a market have increasing returns, there is a barrier to entry—a new firm of efficient scale may not be profitable.

35. Just as a claim that the long-distance market fits textbook perfect competition would not be credible, a claim of pure constant returns would also not be credible. Long-distance suppliers have some fixed costs, including the costs of establishing brand names. But the viability of numerous firms of quite different sizes rules out important increasing returns. Fixed costs and other sources of increasing returns are not sufficiently important to prevent effective, workable competition. MCI offers 9-cent service because it knows that price-sensitive customers will be lured away by rivals if it does not offer such an advantageous price. Some of these rivals are small, but they are nonetheless viable. The long-distance market is large enough and growing fast enough to support many sellers that are big enough to achieve efficient scale.

V. Effect of the Merger on WorldCom's Role as a Supplier of Wholesale Service

36. A major theme of both reply affidavits is that WorldCom, once the hero of the resellers, will withdraw from that role. The pure resellers will be left without a committed wholesale supplier. WorldCom will withdraw, according to this argument, because its sales to resellers will take away lucrative retail business from its new affiliate, MCI.

37. In theory, both MCI and WorldCom, both individually, pre-merger, and combined, post-merger, would prefer that resellers not take away their own retail customers. But both MCI and WorldCom nonetheless now both sell very large volumes of long distance service to resellers. They do so for one reason: they understand that if they do not sell capacity to a reseller, the reseller can buy the capacity elsewhere or build it. Long distance capacity continues to grow; at the same time, the cost of building capacity is falling, and the situation threatens to continue. Because the merger will in no way reduce the intense competition in the supply of long distance capacity, the profitability to MCI and WorldCom of sales in this market will be very unlikely to alter as a result of the merger.

38. I do not know what will be the ultimate mix of resold long distance service and facilities-based sales of long distance service, either for MCI/WorldCom or for the industry as a whole. But any effect of the merger on MCI and WorldCom's customer base will not affect the overall level of capacity or competition in the long distance market, whether for retail or wholesale. Moreover, if MCI/WorldCom is successful in superior marketing to retail customers, retail customers do not lose from this. MCI/WorldCom would not idle any capacity that WorldCom presently uses to supply resellers. Instead, MCI/WorldCom would use that capacity to supply retail customers directly. Thus, the merger would not, even if MCI/WorldCom would sell relatively more long distance service to retail customers directly and relatively less to wholesale customers, reduce the supply of long distance service or cause consumers to pay more for it. WorldCom's capacity will not disappear from the market. Drs. Harris, Schmalensee, and Taylor failed to pursue the analysis of the incentives to its logical conclusion: MCI/WorldCom can only benefit from changing the relative mix of retail and wholesale service if they do a better job of marketing than the resellers do. Evidently, Wall Street thinks they will be able to do a better job. Consumers, as well as shareholders, can only come out ahead.

39. If the merger causes MCI/WorldCom to sell a higher percentage of its total long distance service to retail customers (and Drs. Harris, Schmalensee, and Taylor have not demonstrated that it will) that change would not be presumptively harmful to consumers. Rather, as I noted at the outset, the relevant test is what happens to prices paid by consumers. In any case, GTE—and other long-distance resellers, which includes virtually all sellers of long distance service—have multiple opportunities to expand their sales by reselling the services of other suppliers, by leasing capacity, by diverting a small fraction of capacity currently under construction for voice rather than data, or by building new capacity. There are no barriers to any of these forms of expansion.

VI. Suppliers to New Long-Distance Carriers

40. An essential assumption of the analysis of Drs. Harris, Schmalensee, and Taylor is that new entrants to the long-distance market—particularly GTE and the Bells—must be pure resellers and must purchase service from a national full-service wholesale provider. Because WorldCom has played a successful role in the wholesale market, the assumption sets up an argument that the prospective entrants will have nowhere to turn if WorldCom affiliates with an existing successful player in both wholesale and retail long distance, MCI.

41. As I explained earlier, the affiliation of MCI and WorldCom will create a company that will have the incentive to sell more long-distance services, necessarily at a lower price. It is possible that this will result in a shift by MCI/WorldCom away from resold long distance service toward facilities-based long distance service, although there is no reason to expect that the merger will affect the relative roles of predominantly facilities-based carriers and predominantly resale carriers in the market as a whole. But this does not mean that the other carriers have nowhere to turn, or even that they will not be able still to turn to MCI/WorldCom. To suggest this would be to suggest that capacity is fixed and cannot be expanded for resellers or for facilities-based sales. Expansion is possible for both.

42. The assumption that entry to long distance can only take the form of pure reselling draws no support from the history of the industry nor the activities of prospective entrants. MCI did not gain its foothold in long distance in the 1970s and 1980s merely by reselling AT&T's services. WorldCom's explosive growth in the 1990s did not rely exclusively on reselling the services of Sprint, MCI, or AT&T. And it is simply untrue that the Bells are universally planning to enter long distance as pure resellers of the products of a national full-service long-distance carrier. For example, US West concluded a deal with Williams in January of this year to provide large amounts of long-distance service.¹ Though numerous carriers, including Williams, are not currently full-service national wholesale providers, they have ambitions to assume that role, by under-pricing WorldCom, MCI, AT&T, Sprint, and other carriers that sell in significant volumes to wholesale customers.

43. A recent survey of switchless resellers' evaluations of their wholesale providers is at complete odds with Drs. Harris, Schmalensee, and Taylor's position that only AT&T, MCI, Sprint, and WorldCom are capable of supplying a reseller.² The survey shows:

- Qwest is rated the best performer in provisioning, customer service, and pricing.
- Qwest and Frontier ranked just behind the large carriers in network quality and reliability.
- Cable & Wireless, LCI, IXC, and U.S. Long Distance, as well as Qwest, all scored above WorldCom in customer service, and Frontier was just behind.
- AT&T, MCI, Sprint, and WorldCom were ranked equally in terms of prices to resellers.

¹ *Communications Today*, January 6, 1998.

² *Phone+* magazine, May 1998.

44. It would be hard to imagine a set of results less supportive of Drs. Harris, Schmalensee, and Taylor's assumption that GTE and the Bells are forced to deal exclusively with WorldCom. That is not at all the way that the existing switchless resellers view the market.

VII. Efficiencies

45. The reply affidavits both criticize studies offered by the merging companies as to the savings that would be enjoyed as a result of the merger. Rather than enter this debate directly, I will restrict my commentary to one point: The evidence from the stock market is persuasive that the efficiencies will be substantial. The combined values of the two firms rose dramatically upon the announcement of the merger. Although in general the rise would be the sum of effects from efficiencies and effects from lessened competition, in this case the evidence is again persuasive that the stock market foresaw no lessening of competition. Subdued competition and higher prices would benefit AT&T, Sprint, and other long-distance carriers. In fact, their value did not change (see Table 2 of my January declaration). As far as the stock market was concerned, the merger had no effect on competition and generated a large increase in shareholder value for the merging firms.

VIII. Evidence from the Stock Market

46. Dr. Harris (paragraph 112) notes that WorldCom enjoyed returns in the stock market well above the S&P 500 in the period starting with the announcement of its bid for MCI. He attributes this entirely to the anticipation of higher prices and restricted supply—the anti-competitive effects he attributes to the merger. His interpretation of the evidence from the stock market is flawed for the reason I mentioned in the previous section—he neglects the enhanced shareholder value that comes from efficiencies. The proper analysis, nowhere considered by Dr. Harris, must come to terms with the stock market's change in the valuation of rivals, who stand to gain from higher prices but not from MCI/Worldcom's greater efficiencies. Shareholders of rivals saw no systematic excess returns around the time of the announcement of the merger. This conclusion holds regardless of the length of the window over which excess returns are measured.

IX. Inferences from Entry

47. Dr. Harris infers the existence of uncompetitive conditions in the long-distance market from the fact that entry is continuing to occur (pp. 16-20). His analysis flies in the face of standard principles of economics. As a general matter, entry occurs as needed to keep the present value of the profits of a potential entrant at zero. Nothing in the analysis of entry supports Dr. Harris's conclusion that there must be excess profit because there is entry. New entrants can build transmission and switching capacity at costs lower than the historical costs of existing carriers. Growth in demand ensures continuing entry and expansion.

X. Do Incumbents Have a Cost Advantage?


48. Drs. Harris, Schmalensee, and Taylor suggest that the incumbents in the long-distance market have a cost advantage over potential entrants. Dr. Harris attributes the advantage to the incumbents' ability to add capacity to existing fiber circuits.

49. In general, a cost-minimizing firm will equate the costs of expanding capacity on all possible margins. It cannot be the case that expanding existing circuits is always cheaper than installing new ones. Of course, at particular times along particular routes, expansion will be preferable to new construction, but this is counterbalanced by other times and other locations where new construction is preferred. There cannot be a systematic difference favoring incumbents from this source. The fact that new entrants are building new capacity by constructing new fiber routes demonstrates that incumbents do not always have an insuperable advantage.

XI. Conclusion

50. The reply affidavits by Harris and Schmalensee and Taylor do not present any facts or analysis with respect to long distance telephone service that should stand in the way of the approval of the merger. The affidavits focus very narrowly on only one activity in the long distance market—the offering of wholesale capacity to switchless resellers. Their analysis is wrong for two reasons. First, they underestimate the ability of existing firms and new firms to supply to resellers the capacity which will assure that resellers will not see a price increase post-merger. Second, by failing to look beyond the single issue of the supply to switchless resellers, they never address the core issue: How will the merger affect the prices for long distance service paid by consumers? My answer to this, based on the analysis described in this affidavit and my earlier affidavit, is that the merger will bring lower, not higher, prices and thereby benefit consumers—even if it harms GTE as a competing supplier of long distance service.

I declare under penalty of perjury that the foregoing is true and correct, to the best of my knowledge.



Robert E. Hall

Menlo Park, California, July 1, 1998.